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Evidence in value-for-money auditing.

(Discussion paper no. 2)

Office of the
Auditor General
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Bureau du
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DISCUSSION PAPER NO. 2

EVIDENCE IN VALUE-FOR-MONEY AUDITING

by

MAIER ZELMAN

JANUARY 1980

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The main products of comprehensive audits are audit opinions or audit reports. The form of opinions that are given by the Office is directed by its legislated mandate. The form is also affected by the type and extent of information required to be reported to Parliament through the Estimates and Public Accounts. Although the auditor is not a guarantor of the issued report or opinion, s/he obviously owes it to his/her professional conscience, Management of the audited organization, Parliament, or other properly interested parties to be both honest and fair.

This then raises the question of how much and what kind of evidence is needed to support an opinion or a statement in a report.

Perhaps a good point of beginning is the statement in the CICA Handbook that:

> Sufficient appropriate audit evidence should be obtained, by such means as inspection, observation, enquiry, confirmation, computation and analysis, to afford a reasonable basis to support the content of the report.

The CICA Handbook then further goes on to say that:

> Audit evidence consists of the source documents and accounting records underlying the financial statements and all other information which is pertinent to the auditor's examination. The accounting records, of themselves, do not provide sufficient appropriate audit evidence.

Effectively, this only says that "evidence is evidence", but the CICA Handbook goes on to discuss two specific characteristics of evidence. These are sufficiency which is stated to be the measure of quantity of audit evidence obtained, and appropriateness, that is stated to be the measure of this quality. In this same context, the Handbook makes what is perhaps the most important statement on this subject "Normally, the auditor finds it necessary to rely on evidence that is persuasive rather than conclusive" and a little later that "the auditor is not seeking absolute certainty".

Unfortunately, the CICA Handbook does not discuss the basic nature of evidence and we shall next address ourselves to that subject. Beginning with the definitions in the Oxford dictionary, it is stated to be:

- the quality or condition of being evident;
- that which makes evident;
- grounds for belief;
- that which tends to prove or disprove any conclusion; and
- information that is given in a legal investigation to establish the fact or point in question.

Looking at these definitions they seem to describe what evidence does, rather than what it is. Thus we will try to answer two questions.

(a) What constitutes evidence?

(b) How much and what type of evidence is enough to develop a reportable inference?

For ease of analysis both these questions will later be sub-divided into financial audits and management audits.

Types of Evidence

Direct Observation. This is normally accepted only in the first person and consists of statements such as: "I saw this," "I touched this," "I measured this using that device."

Hearsay. The statement that "he said that he had committed the murder" is a direct observation of what he said but hearsay about the murder. In general, hearsay is not evidence unless specifically admitted as such. For instance in many legal jurisdictions hearsay evidence is not accepted in criminal trials.

Documentary. This is the specific document referred to or a certified copy of such a document.

Circumstantial. "He must have known --- to have done ---" or "these tracks must have been made by those shoes."

Judicial Notice. In law, judges must base their rulings on the evidence presented to them by the advocates. However, there are a certain number of situations in which a judge may take judicial notice of things which everyone is presumed to know and these do not have to be proved in court, for instance, the fact that fingerprints are unique to each person, or that matching ballistics markings indicate that the same weapon was used. In our case, the fact that generally accepted accounting principles are accepted by the profession or the legitimacy of the sovereignty of Parliament need not be proved in support of an audit opinion.

Expert Opinion. When this is used the "expert" must first be qualified, that is, it must be demonstrated that he or she is indeed an expert.

Looking at these types of evidence there seem to be two distinct groups. The first group might be identified on the basis that evidence = evidence (hard). This includes direct observation, hearsay when admitted, and documentary evidence.

The second group could be classified on the basis that, in actual fact, this evidence = inference (soft) and this includes circumstantial evidence, judicial notice, and expert opinion. It should be noticed that in practice, if we restrict ourselves to using <u>hard</u> evidence, we cannot prove the non-existence of controls unless we can persuade someone to sign a document which is tantamount to a confession. This brings us back to the second question of "How much and what type of evidence is enough to develop a <u>reportable</u> inference?"

Before we begin to answer this question we have to make a prior determination which has perhaps been paraphrased in Miles Law which states: "Where you stand depends on where you sit." Specifically, this means that we must determine the nature of our subject matter and the particular role of the auditor before we can make this determination of how much and what type of evidence is required. So perhaps we could begin by looking at some different subject matters and see how members of different professions treat evidence.

History

Theories of historical behaviour are normally based on a concept of social structure. This means that different concepts on the part of the individual historian to-day lead to different historical "realities". An interesting example of this syndrome is the entirely different views of world history held by Russia, China, the United States, and Great Britain. In fact if one looks at any reputable journal of history one may find completely different <u>descriptions</u> of behaviour in a given time period at a given location, these descriptions being entirely dependent upon the particular historian's concept of social structure.

Social Science

Even where the data is "hard," evidence includes assumptions such as linearity of equations, equilibrium states, or for that matter the limits of the researchers mathematical ability. Everyone is well aware of some of the modern techniques such as econometrics and mathematical economics used in social science. Perhaps one of the best criticisms of these techniques has been stated by

the well known author, Anonymous, that: "Advanced econometrics is a sophisticated way of lending spurious precision to conclusions drawn from unwarranted assumptions."

In this area too, the literature is full of learned hypotheses, very often not borne out by the facts as revealed, but of sufficiently high quality to be accepted by review committees consisting of senior members of the profession.

Medicine

The evidence used in medicine, in general, is observation followed by logic applied on inadequate information but with a strong feedback loop (consisting of mortality data, post mortems, or more observations to see if the guess last time worked). The feedback loop of course, hopefully includes both the observations and the logic.

Law

Here we have two completely different systems of evidence since in criminal law guilt must be proved "beyond a reasonable doubt" but in civil law the adjudication is on the basis of "a preponderance of the evidence". To complicate this even further it should be noted that the law does <u>not</u> require consistency. The same evidence may lead to two mutually exclusive findings in two different cases about the same matter.

As an example, if someone is charged with driving through a red light and hitting another car, it is quite possible that the civil suit for damages succeeds in providing to the satisfaction of the judge that the driver did indeed drive through a red light while on the criminal side, or breach of the highway code, the judge may find on exactly the same evidence that the driver did not go through a red light.

Thus there seem to be some major differences between the nature evidence in law and non-law and this perhaps can best be set up in the form of a matrix.

Law	Non-Law
Presentation by disputants before an uninformed decider	Inquiry, reflection and decision by trained investigators
Findings, after all appeals are exhausted, are final	New evidence will cause reopening of the case

This then raises the question of whether financial/management auditors are closer to lawyers or non-lawyers?

This however has not yet exhausted the complexity of the problem since there are two different kinds of lawyers, that is, advocates and judges and their needs for evidence are quite different. The advocate needs enough "evidence" to decide that there is a case to be tried. The judge however needs enough "evidence" to decide right and wrong and impose sanctions.

Here perhaps we begin to see a glimmer of light at the end of the tunnel. Perhaps the financial auditor is roughly analogous to a jury of professionals, since his/her ruling is effectively unappealable although the auditor does not impose sanctions. For instance, the "clean" opinion is roughly equivalent to not guilty or the Scottish verdict not proven. A "qualified" opinion is roughly equivalent to partially guilty. An "adverse" opinion is roughly equivalent to guilty as hell. To "refuse" an opinion is roughly equivalent to hang the bastard.

If we accept this analogy it would indicate that, for the attest auditor, the standard of evidence has to be "beyond a reasonable doubt" subject to rules, i.e., generally accepted accounting principles and generally accepted auditing standards.

For management auditors findings can be, and are, rebutted by the Management of the audited organization. Most of the rules in this area are, in fact, opinions. This would indicate that the standards of evidence for the management auditor should perhaps be the civil law approach of the plaintiff's advocate. This means that the auditor must be reasonably certain that there is a probability of there being a case, subject to preponderance of the evidence. Adequate evidence in this case would be what a "reasonable man" would accept as being grounds for belief. This would then include circumstantial evidence and the whole range of opinions implicit in the common law of "the reasonable man".

Information Sources

For a working guide to evidence in attest auditing read Section 5300 "Audit Evidence" in the CICA Handbook, which is attached as Appendix A, and in "Fraud and Error" published by the CICA in October 1979.

The "reasonable man" is well described, in a humorous vein, in "Uncommon Law" by A.P. Herbert.

Evidence in different professions is treated in a rather pendantic but exhaustive (and exhausting) fashion in "Evidence and Inference" edited by Daniel Lerner.

GENERAL AUDITING — SECTION 5300

audit evidence

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INTRODUCTION AND DEFINITION

Examination standard (iii) (see GENERALLY ACCEPTED AUDITING STANDARDS, Section 5100) states: .01

> *"Sufficient appropriate audit evidence should be obtained, by such means as inspection, observation, enquiry, confirmation, computation and analysis, to afford a reasonable basis to support the content of the report."*

Audit evidence consists of the source documents and accounting records underlying the financial statements and all other information which is pertinent to the auditor's examination. The accounting records, of themselves, do not provide sufficient appropriate audit evidence. .02

This Section provides guidance in general terms as to the attributes of audit evidence and the manner in which the auditor obtains and evaluates such evidence. While the auditor is concerned with audit evidence in all phases of his audit, this Section deals primarily with such evidence obtained by performing compliance and substantive procedures. .03

The principal distinction between compliance procedures and substantive procedures is that compliance procedures are used to gain a sufficient degree of assurance whether the prescribed internal controls are operating effectively, whereas substantive procedures are used to gain evidence as to the validity of the data produced by the accounting system. Although the objectives of compliance and substantive procedures are different, both use the same methods of obtaining evidence (see paragraphs 5300.22-.31) and the concepts of sufficiency and appropriateness (see paragraphs 5300.09-.21) also apply to both. .04

NECESSITY FOR PERFORMING SUBSTANTIVE AUDITING PROCEDURES

.05 It is important to recognize the interrelationship between examination standard (ii) and examination standard (iii). Examination standard (ii) requires an appropriately organized study and evaluation of those internal controls on which the auditor subsequently relies in determining the nature, extent and timing of auditing procedures. Where the auditor has relied on internal control, such reliance and substantive auditing procedures must together provide the assurance he seeks to support the content of his report. Where the auditor has not relied on internal control, such assurance must be provided by substantive auditing procedures more extensive than those which would have been applied if internal control had been relied on. Such procedures may also differ as to their nature and/or timing.

.06 Although the existence of an effective system of internal control reduces the probability of fraud and error, it does not eliminate the possibility that they might have occurred. Because of this and other inherent limitations, such as management overriding an otherwise effective control, the auditor's evaluation of.internal control cannot by itself provide him with sufficient evidence that the financial statements are free of material mis-statement. Accordingly, the auditor will need to perform some substantive auditing procedures. This is so even where there is a well-designed internal control system and the compliance procedures indicate the controls within it have operated effectively throughout the period of reliance.

.07 One inherent limitation of internal controls is that they tend to be directed at regularly recurring transaction streams, and not at unusual transactions. It follows that in performing his substantive auditing procedures, the auditor needs to recognize the possibility of unusual transactions, which may not be subject to the usual internal controls.

.08 ▶ *The auditor should perform substantive auditing procedures. This is so even when the internal control system is well-designed and compliance procedures indicate that the controls within it have operated effectively throughout the period of reliance.* [JAN. 1978]

SUFFICIENCY AND APPROPRIATENESS OF EVIDENCE

.09 The concepts of sufficiency and appropriateness are interrelated. As used in examination standard (iii), sufficiency is the measure of the quantity of audit evidence obtained and appropriateness is the measure of its quality. The decision as to whether a sufficient quantity of evidence has been obtained will be influenced by its quality. Normally, the auditor finds it necessary to rely on evidence that is persuasive rather than conclusive. Thus, he frequently seeks evidence from different sources or of a different nature to support the same assertion.

.10 When performing substantive procedures the auditor's judgment as to what is sufficient appropriate audit evidence is influenced by such factors as:

(a) the adequacy of internal control;
(b) materiality;
(c) the degree of risk of mis-statement through fraud or error (see paragraph 5300.45);
(d) the experience gained during previous audit examinations as to the reliability of the client's records and representations;
(e) the persuasiveness of the evidence; and
(f) fraud or error found while performing his auditing procedures.

When performing compliance procedures, the auditor would consider the above factors, where applicable, and the particular factors described in INTERNAL CONTROL, paragraphs 5220.16-.21.

Sufficiency

The auditor does not normally examine all available information but forms his conclusions on an entire set of data by examining only a part of it. This procedure is commonly referred to as testing. .11

The reasons for examining only part of the data to gain reasonable assurance as to the reliability of the entire set of data, and therefore accepting some uncertainty in the results of audit tests, include: .12
(a) the auditor is not seeking absolute certainty;
(b) evidence obtained from one source, corroborated by evidence obtained from another source, will normally provide increased assurance;
(c) examining all data may still not provide absolute certainty, as for example, where there are certain unrecorded transactions; and
(d) the cost of examining every entry in the accounting records and all supporting evidence would generally be uneconomic.

Tests fall into two basic categories: .13
(a) specific item tests whereby the auditor examines individual items which he considers should be examined because of their size, nature or method of recording. For example, in selecting accounts receivable for confirmation, the auditor may select all those over a certain monetary amount and all overdue accounts;
(b) representative item tests whereby the auditor's objective is to examine an unbiased selection of items. For example, the auditor may make a representative selection of personnel records for the purpose of testing that changes in payroll rates have been properly authorized.

The auditor may combine both categories of testing as for example, when he selects for examination all items over a certain monetary amount and a further group of representative items.

The determination of an appropriate sample on a representative basis may be made using either statistical or non-statistical methods. Whether statistical or non-statistical methods are used, their common purpose is to enable the auditor to reach a conclusion about an entire set of data by examining only a part of it. Statistical sampling methods .14

allow the auditor to express in mathematical terms the uncertainty he is willing to accept and the conclusions of his test. The use of statistical methods does not eliminate the need for the auditor to exercise his judgment. For example, he has to determine the degree of risk he is willing to accept and make a judgment as to materiality.

Appropriateness

.15 The appropriateness, or quality, of audit evidence relates to its relevance and reliability. To be relevant, audit evidence must assist the auditor in achieving his audit objective. The reliability of audit evidence depends on its nature and source.

.16 The auditor is concerned with the following assertions with respect to internal control:

Existence	— that it exists;
Effectiveness	— that it operates effectively;
Continuity	— that it has so operated throughout the period of intended reliance.

The auditor seeks evidence with respect to these assertions primarily through the performance of compliance procedures (see INTERNAL CONTROL, paragraphs 5220.11-.21).

.17 Financial statement items embody the following assertions:

Existence	— that an asset or a liability of the enterprise exists at a given date;
Occurrence	— that a transaction took place which pertains to the enterprise;
Completeness	— that there are no unrecorded assets, liabilities or transactions;
Ownership	— that an asset is owned by the enterprise at a given date;
Valuation	— that an asset or liability is recorded at an appropriate carrying value;
Measurement	— that a revenue or expense transaction is recorded in the proper amount and allocated to the proper period;
Statement presentation	— that an item is disclosed in accordance with generally accepted accounting principles (or, where applicable, with another appropriate basis of accounting).

The auditor seeks evidence with respect to these assertions primarily through the performance of substantive procedures. Obtaining evidence relevant to one assertion, for example, existence of inventory, will not compensate for failure to do so for another, for example, its valuation. Some assertions will be virtually self-evident to the auditor, for example, the "valuation" of cash, while others, such as the "completeness" of accounts payable, may require extensive procedures.

.18 In evaluating each internal control on which he intends to rely and in examining each financial statement item, the auditor uses his professional judgment to:

(a) identify the relevant underlying assertions;
(b) determine the types of evidence available with respect to each assertion; and
(c) determine from the available evidence, what constitutes sufficient appropriate evidence with respect to each assertion.

Audit evidence may be classified by its nature — documentary, oral or visual — and by its source — the auditor, the enterprise or third parties. For example: .19

(a) the auditor develops evidence by such means as:
  (i) physical inspection of assets;
  (ii) recomputation of calculations; and
  (iii) observation of the performance of internal control routines.
(b) the enterprise produces evidence in the form of:
  (i) source documents such as copies of sales invoices;
  (ii) accounting records and reports; and
  (iii) oral and written representations made by management and employees.
(c) third parties provide evidence in the form of:
  (i) independent records and reports such as industry statistics;
  (ii) source documents such as suppliers' invoices; and
  (iii) oral and written representations at the request of the auditor, such as accounts receivable confirmations.

Generally, evidence developed by the auditor is more reliable than evidence obtained from the enterprise or third parties, documentary evidence is more reliable than oral evidence and external evidence is more reliable than internal evidence. The auditor may gain increased assurance when audit evidence obtained from different sources or of a different nature is consistent. In these circumstances, he may obtain a cumulative degree of assurance higher than that which he attaches to the individual items of evidence by themselves. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the reliability of each remains in doubt until further procedures have been performed to resolve the inconsistency. .20

▶ *The auditor should evaluate all the evidence he has obtained and assess its sufficiency and appropriateness. He should consider evidence supporting and evidence refuting an assertion and should be alert for evidence supporting one assertion but inconsistent with that supporting another.* [JAN. 1978] .21

METHODS OF OBTAINING EVIDENCE

The auditor obtains evidence by the performance of a combination of the auditing techniques described in examination standard (iii) — inspection, observation, enquiry, confirmation, computation and analysis. These techniques apply to computerized accounting records although the method of application may differ from that used in other systems. .22

Inspection

.23 Inspection consists of looking at records and documents or at assets having physical substance. It encompasses techniques of varying degrees of thoroughness such as examining, perusing, reading, reviewing, scanning, scrutinizing and vouching.

.24 Inspection of records and documents provides evidence of varying degrees of reliability depending on their nature and source and the effectiveness of the internal controls over their processing. There are three major categories of documentary evidence, each providing a different degree of reliability to the auditor:

(a) Documentary evidence created and held by unrelated third parties
Documentary evidence created and held by unrelated third parties (such as published records of dividends) is beyond the control of the enterprise and therefore normally constitutes highly reliable evidence.

(b) Documentary evidence created by third parties and held by the enterprise
The majority of the externally-created documents inspected by the auditor will be in the enterprise's possession and will include such items as bank statements, purchase invoices and customers' purchase orders. The reliability of these documents as audit evidence depends primarily on the controls which exist to prevent their being falsified, suppressed or improperly altered by someone within the enterprise.

(c) Documentary evidence created and held by the enterprise
Documents created within an enterprise generally represent less reliable evidence as they may be susceptible to falsification, suppression or improper creation or alteration. Some of these documents may pass through the hands of a third party, for example cheques, while others such as sales invoice copies do not leave the possession of the enterprise. The reliability of these documents as audit evidence depends on the controls which exist to prevent their being falsified, suppressed or improperly created or altered.

Inspection of physical assets provides highly reliable evidence with respect to their existence but not necessarily as to their ownership or value.

Observation

.25 Observation consists of looking at a process or procedure being performed by others. Observation of procedures provides highly reliable evidence as to the manner of their performance at a given point in time but not necessarily as to their performance at other times.

Enquiry and confirmation

.26 Enquiry consists of seeking appropriate information of knowledgeable persons within or outside the enterprise. Enquiries may range from formal written enquiries addressed to third parties to informal oral en-

quiries addressed to persons within the enterprise. An example of the former is a confirmation enquiry to a bank with respect to deposit or loan balances and an example of the latter is an enquiry of client personnel regarding an internal control procedure. Responses to enquiries may provide the auditor with information which he did not previously possess or may provide him with corroboration. A response from a person within the enterprise does not usually constitute sufficient appropriate audit evidence in itself but requires corroboration. Such corroboration may include making further enquiries from other appropriate sources within the enterprise. Consistent responses from different sources provide an increased degree of assurance.

Confirmation consists of an enquiry, usually written, to corroborate information contained in the accounting records; for example, a confirmation sent to a debtor with respect to an amount receivable from him. Written responses to confirmation requests received directly by the auditor usually provide highly reliable evidence, especially if from unrelated third parties. .27

The degree of reliability which the auditor attaches to the responses to his enquiries and confirmations will be affected by his judgment as to the objectivity and knowledge of the respondent. When responses to important enquiries and confirmations are not in writing, it is highly desirable that they be documented in the auditor's working papers. .28

Computation

Computation consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations. Computation provides the auditor with evidence which is highly reliable with respect to arithmetical accuracy. .29

Analysis

Analysis consists of: .30

(a) identifying the components of a financial statement item or account to determine matters which require investigation; or

(b) studying and evaluating the interrelationships between elements of financial and other information. This technique is sometimes referred to as analytical review and may include:

  (i) a comparison of current financial information with that of previous periods, with that budgeted for the current period and, where appropriate, with statistics available for the enterprise and the industry; and/or

  (ii) a study of the interrelationships of elements of financial information that would be expected to conform to a predictable pattern.

Analytical review assists the auditor in considering the reasonableness of items being examined and may highlight matters requiring further investigation. The auditor will usually perform analytical review .31

as an overall test of the reasonableness of the financial information. Even when the auditor is satisfied that there is an effective system of internal control, an analytical review, by itself, would not normally provide the auditor with sufficient appropriate audit evidence. However, it frequently augments the reliability of evidence obtained by other techniques.

TIMING OF SUBSTANTIVE AUDITING PROCEDURES[1]

.32 The auditor may choose to carry out substantive auditing procedures prior to the balance sheet date. When the auditor:

(a) performs substantive auditing procedures on the transactions building up to an account balance (as is normally the case with accounts such as sales or fixed assets) for less than the entire period; or

(b) obtains evidence supporting an account balance (as is normally the case with accounts such as inventories and depreciation expense) as at a date other than the balance sheet date;

he will need to obtain sufficient assurance that the account balances at the balance sheet date have not been mis-stated because of incorrect accounting entries and unrecorded transactions in the intervening period. This assurance for the intervening period may be obtained by performing any combination of:

(i) compliance procedures to enable him to place substantial reliance on internal control;

(ii) substantive tests of transactions; and

(iii) other substantive auditing procedures, such as analytical review.

.33 When substantial reliance cannot be placed on internal control, the auditor may find it necessary to perform the major portion of his substantive auditing procedures with respect to balance sheet accounts as of the balance sheet date and, with respect to income statement items, up to the balance sheet date.

.34 ▶ *When the auditor performs substantive auditing procedures on the transactions building up to an account balance for less than the entire period or obtains evidence supporting an account balance as at a date other than the balance sheet date, he should obtain sufficient assurance that the account balances at the balance sheet date have not been mis-stated because of incorrect accounting entries and unrecorded transactions in the intervening period.* [JAN. 1978]

.35 The auditor needs to consider whether to examine interrelated items at the same time. For example, a purchase may be included in physical inventory, but not recorded in purchases and accounts payable and ac-

[1] Timing of compliance auditing procedures is discussed in INTERNAL CONTROL, paragraphs 5220.13-.17.

cordingly, the auditor would normally perform certain auditing procedures on the related trade accounts payable as at the inventory count date.

Events or transactions may occur or new information may become available subsequent to the date of the balance sheet but prior to the date of the auditor's report that require reflection in the financial statements. .36

▶ *The auditor should consider audit evidence available up to the date of his report which may require reflection in the financial statements being examined.* [JAN. 1978] .37

Subsequent to the date of his report the auditor has no responsibility to seek out further evidence. However, if he becomes aware of facts which would have caused him to amend his opinion had he known about them, he would need to consider what action would be appropriate. Certain statutes have set out the auditor's responsibilities in this situation. .38

FRAUD AND ERROR

Paragraphs 5300.39 to .55 discuss fraud and error and provide guidance when the auditor encounters circumstances that cause him to suspect, or when he determines, that fraud or error has occurred. .39

The following definitions have been adopted for purposes of the Auditing Sections of this Handbook: .40

(a) "error" refers to mistakes affecting the financial statements, such as:
   (i) arithmetical or clerical mistakes;
   (ii) misapplication of accounting principles; and
   (iii) the oversight or misinterpretation of facts;

(b) "fraud" refers to acts committed with an intent to deceive involving either misappropriation of assets or misrepresentations of financial information either to conceal misappropriations of assets or for other purposes, by such means as:
   (i) manipulation, falsification or alteration of records or documents;
   (ii) suppression of information, transactions or documents;
   (iii) recording of transactions without substance; and
   (iv) misapplication of accounting principles.

The auditor's objective in making an examination of financial statements in accordance with generally accepted auditing standards is to express an opinion on the fairness with which they present the financial position, results of operations and changes in financial position in accordance with generally accepted accounting principles. The auditor recognizes that the financial statements may be mis-stated as a result of fraud or error. Accordingly, in obtaining sufficient appropriate audit evidence to afford a reasonable basis to support the content of his .41

report, the auditor seeks reasonable assurance, through the application of procedures that comply with generally accepted auditing standards, that fraud and error which may be material to the financial statements have not occurred or that, if they have occurred, they are either corrected or properly accounted for in the financial statements. The auditor has no separate or additional responsibility to detect fraud or error. The prevention and detection of fraud and error is primarily a management responsibility.

.42 In an examination made in accordance with generally accepted auditing standards, the auditor fulfills his professional responsibility by complying with those standards. Such examination is subject to the limitations imposed through the use of testing and the inherent limitations of internal control (see INTERNAL CONTROL, paragraph 5205.04). Because of these limitations, there is a possibility that fraud or error may not be detected, even if material in amount. The existence of fraud or error which the auditor does not discover during his examination does not necessarily indicate that he has failed to adhere to generally accepted auditing standards. Rather, the question of adherence to such standards would be determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the results of those procedures. The auditor expresses an opinion; he does not give a guaranty.

.43 The degree of assurance that fraud or error, which may be material to the financial statements, has not occurred would normally be lower in the case of fraud, since fraud is usually accompanied by acts designed to conceal its existence. For example, collusion between personnel of the enterprise and outside parties may result in the presentation to the auditor of falsified documents that appear genuine and that would normally be accepted as such. The auditor does not normally perform specific procedures on the assumption that fraud has occurred but draws a major part of his assurance from the absence of cause for suspicion. In the absence of suspicions as to the validity of documents, it is reasonable for the auditor to rely on such evidence.

.44 When accepting an appointment, the auditor may wish to inform management, preferably in writing, that he undertakes to perform his audit in accordance with generally accepted auditing standards and that fraud and error may not be detected by the application of procedures that comply with generally accepted auditing standards.

.45 Within the limitations of the auditing process, the auditor approaches his examination taking into consideration the degree of risk of mis-statement through fraud or error. This risk may be affected by such factors as:

(a) the nature of the item — for example, inventory is usually more susceptible to mis-statement than is long-term debt;

(b) the nature of the business carried on by the enterprise — for example, the financial statements of an enterprise subject to erratic performance may be more susceptible to mis-statement;

(c) the types of fraud or error that could occur and the possibility of their occurrence taking into consideration the adequacy of internal controls; and
(d) situations which may exert an unusual influence on management — for example, a contemplated public offering, a management profit sharing arrangement or a financially weak enterprise.

During his examination, the auditor may encounter specific circumstances that make him suspect that the financial statements may be materially mis-stated. Examples of circumstances which, while not necessarily indicating that fraud or error exists, may alert the auditor to such a possibility, are: .46
(a) the accounting records being seriously incomplete or inadequate;
(b) conflicting evidence on important matters;
(c) unusual documentary evidence such as handwritten alterations to documents or handwritten documents where they would usually be typed;
(d) unusual transactions by virtue of their nature or complexity, particularly close to the year end; and
(e) situations described in paragraph 5300.53.

If the auditor suspects that fraud or error exists, he needs to perform procedures to support or dispel his suspicion. If the auditor is unable to dispel his suspicion, he would normally discuss the matter with management including the nature and extent of any further investigation designed to determine whether fraud or error exists. When fraud or error is found to exist, or when his suspicion of fraud or error cannot be dispelled, the auditor would assess its effect or possible effect on the financial statements and on the content of his report and communicate his findings to management on a timely basis, so that prompt and appropriate action can be taken. If the auditor is satisfied that a fraud or possible fraud could not be material to the financial statements, he would nevertheless inform management of the matter. .47

Unless the circumstances clearly indicate otherwise, the auditor is not justified in assuming that an instance of fraud or error is an isolated occurrence. He would estimate its possible magnitude in the entire set of data. If its occurrence should have been prevented or detected by an internal control on which the auditor is relying, he would need to consider his evaluation and therefore the nature, extent and timing of substantive auditing procedures. In the case of a fraud, the auditor would consider the implications in light of the other responsibilities of the individuals involved. If a member of management is involved, there are further audit implications which are discussed in paragraphs 5300.50 to .55. .48

▶ *The auditor should assess the audit implications of all frauds and errors which come to his attention and consider their effect on the financial statements.* [JAN. 1981] .49

Management fraud

.50 When the auditor encounters or suspects fraud that may involve management, he needs to re-consider his assumption of management's good faith and the appropriate level of management to whom to communicate his findings. The auditor normally designs his auditing procedures on the assumption of management's good faith. To work on the reverse assumption would be impractical because the auditor would not be able to place any credence in the accounting records nor would he be able to place any credence in representations made by management or by employees under management's control.

.51 To provide a basis for the assumption of management's good faith, the auditor, in a new engagement, would normally make enquiries as to the identity and reputation of owners and management and would consider the prospective client's reputation, its financial statements and audit reports. He is required under rules of professional conduct to make enquiries of the predecessor auditor, if any, as to whether there are any circumstances he should take into account which might influence his decision to accept the appointment. On continuing engagements, the basis for the assumption of management's good faith is the experience gained during previous audits. The auditor would reconsider this basis when there is a significant change in management or owners.

.52 Internal control may be ineffective against fraud committed by management since management may be in a position to:

(a) override the controls that would prevent similar frauds by other employees;
(b) direct subordinates to record transactions incorrectly or to conceal them; and
(c) suppress information relating to transactions.

Consequently, the auditor would be aware of the importance of management's good faith to the effective operation of internal control.

.53 During his examination, the auditor may encounter circumstances which, while not necessarily indicating that management lacks good faith, may alert the auditor to such a possibility. Examples of such circumstances are:

(a) information being provided unwillingly or only after unreasonable delay;
(b) a limitation in the scope of the examination imposed by management; and
(c) identification of important matters which were previously undisclosed.

If the auditor suspects that a member of management is involved in fraud, he would perform procedures to confirm or dispel his suspicion. When the auditor confirms or is unable to dispel his suspicion that a member of management is involved, there would be concern as to the credibility of any representations made by that person on which the auditor had intended to rely. In such circumstances, the auditor would be unable to rely on that person's good faith and would seek alternate representations or other audit evidence. The auditor would also consider all the circumstances including the amounts in question and the likelihood of collusion with higher levels of management in determining an appropriate representative of the enterprise to whom to report. In most cases, it would be appropriate to report the matter to a level of management above that thought to be implicated. .54

When the highest level of management is doubted, the auditor may encounter difficulties in obtaining alternate representatives or other audit evidence and in determining an appropriate representative of the enterprise to whom to communicate his findings. In such circumstances, it may not be possible or practical for the auditor to complete his examination and he should consider obtaining legal advice as to his responsibilities and the appropriate course of action. .55

RELATIONSHIP TO THE REPORTING STANDARDS

The auditor relies on his professional judgment in deciding which procedures will give him sufficient appropriate audit evidence, recognizing that there may be occasions when he will be unable to gain reasonable assurance as to the reliability of the accounting records and the financial statements. The auditor then evaluates the audit evidence obtained to determine the content of his report. .56

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